

MACROCOSM

## The Game Changes for Russian Crude

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Price-caps flopped. The Urals discount is gone. Russian infrastructure is now under attack.

There's been an important reversal in global crude oil trading dynamics, which is causing us to nudge up our forecasted trading range, from \$70 to \$85 per barrel (in Brent terms), to \$75 to \$90.

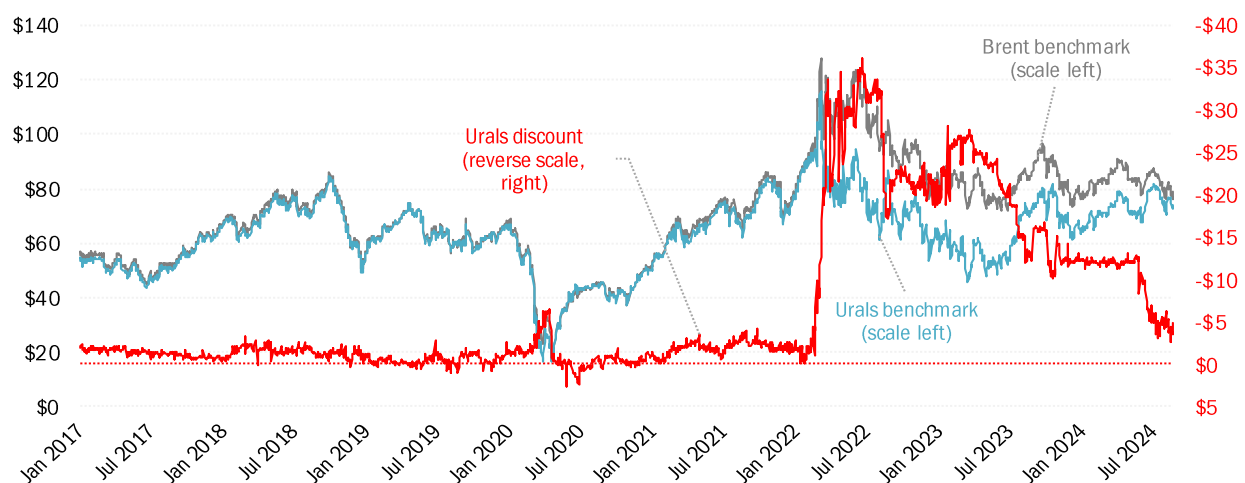
- The critical trigger here is that the West's strategy to blunt Russia's war-fighting capability has shifted from trying to constrain the price at which they export their crude oil – while preserving volumes – to reducing volumes – regardless of price.
- When Russia invaded Ukraine two and a half weary years ago and global oil prices spiked to highs not seen since 2008, we wrote that prices would then fall sharply because Western sanctions would make Russia a desperate seller, weakening the price structure across the whole market (see [“The Bear/Bull Case in the Russian Oil Ban”](#) March 16, 2022). That turned out to be a great call, with global prices falling sharply and remaining soggy despite ongoing geopolitical tensions in Ukraine, and then new ones in the Middle East. The Urals benchmark traded at a substantial discount to Brent (please see the chart below) as Russia was forced to endure ruinous price concessions to establish new homes for its crude

### Update to strategic view

**OIL:** The discount in Russian oil exports has almost entirely evaporated. The West's \$60 price-cap on Urals crude has proven unenforceable, especially against a poor nation like India which has emerged as the dominant new buyer since the invasion of Ukraine. India's refineries have borne the sunk costs of adapting to Russian crude, and no longer require the discount they could command two ...

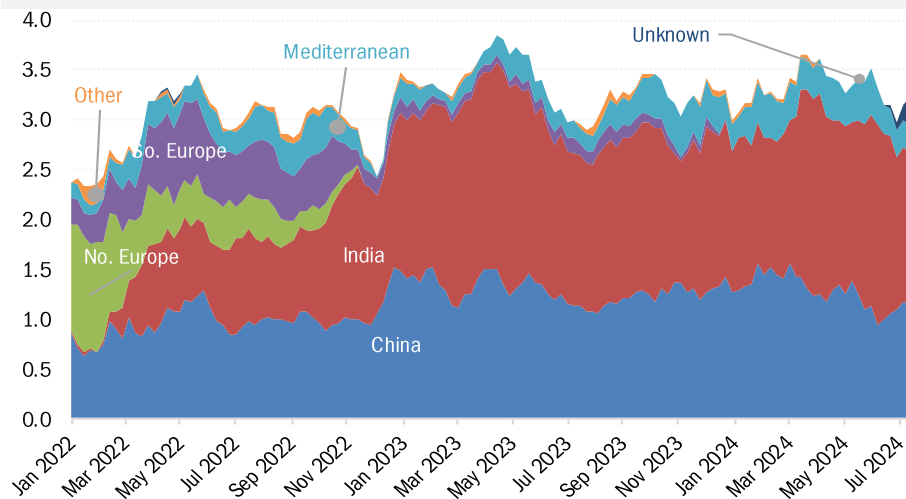
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Global crude oil benchmark price dynamics: Urals versus Brent (USD per barrel)



Source: NYMEX, SPIMEX, TrendMacro calculations

Russian seaborne crude oil exports (millions of barrels per day)



Source: Bloomberg, TrendMacro calculations

exports in Asia, primarily India (please see the chart on the following page). Now the Urals discount is pretty much gone.

- This is, in part, because the discount required to move India from importing almost no Russian oil before the invasion of Ukraine to its present status as Russia's single largest export destination – at 1.4 million barrels per day, exceeding even China – is no longer necessary. India has now made all the necessary engineering adjustments in its refineries to efficiently process Russian crude, so at this point there would be a cost to India to stop using it. Saudi Arabia has recognized this fact and [raised its crude oil price to Asian markets](#) earlier this month.
- At the same time, the G-7-imposed official cap of \$60 per barrel on Russian crude exports (see [“Europe: Winter of Energy Discontent”](#) December 5, 2022) has proven to be unenforceable, as price controls often are (see [“Video: What you're not hearing about Kamala Harris imposing price controls to reduce inflation”](#) August 19, 2024)
- It's been a flop. The Urals benchmark has traded above the price-cap of \$60 consistently for over a year (again, please see the chart on the previous page). For a hemisphere-spanning behemoth like Russia with countless ports and thousands of transport vessels large and small, violations have been hard to detect and interdict.
- So importers have learned that they have nothing to fear from Western sanctions on importers, shippers and insurers who abet trade in Russian oil at a price above the cap.
- This is especially true for the most important importer, India. The West has not been eager to impose [the multi-billion dollar penalties](#) that would be necessary to make a difference when the importer is a desperately poor nation, and one not always unambiguously aligned with Western interests.
- The idea, at least, was to deny Russia the funds to wage war, while not starving the world of much-needed crude. As it turned out, the

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...years ago. Now Ukraine is attacking refining and other infrastructure on Russian soil and making a large dent in export capacity. This risks a black swan event in which Russia could use nuclear weapons in retaliation for attacks on its homeland with Western arms. Oil prices are not higher because the Biden administration has stopped enforcing sanctions on Iran, and is making only tiny moves to refill the drained SPR. A Trump win in November would increase supply by deregulating the domestic industry but reduce it by clamping Iran sanctions back into place. We are nudging up our trading range for Brent to \$75 to \$90.

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world got the crude, but Russia was not starved of revenue. But at least the world got the crude.

- *As the Urals discount has vanished over the last several months, the fact that crude prices have not already moved higher is testimony to how well-supplied global markets have been* (see [“Oil Weirdly in Balance”](#) June 14, 2024). This is in part a function of demand, with global crude consumption only 1.05 million barrels per day, or 1%, higher than just before the pandemic crisis. It would seem the world has learned it doesn’t need as much mobility as it used to think it did – and that means slower growth rates for crude consumption.
- *But now a very different and much riskier strategy has emerged. Ukraine’s President Volodymyr Zelensky has successfully persuaded* his Western allies that the best way to achieve the common goal of reducing income to Russia’s war machine is to limit the *volume* of Russian crude oil and petroleum product exports, not cap the *price*. In May, [Zelensky received permission from US President Joseph Biden](#) to do just that.
- So while Ukraine had attacked Russian oil infrastructure intermittently in 2023, *this year has seen a heightened tempo of drone attacks, knocking out an estimated 900,000 barrels per day of refining capacity and disrupting pipeline flows to export hubs.* Last week, Ukrainian forces crossed the border and [took out Russian airports and seized Sudzha](#), a key gas metering station.
- Russian crude oil exports have fallen by about 600,000. This is both because of the attacks and because [the Kremlin has ordered more feedstock be devoted to domestic refining](#), thereby lowering input costs for the domestic market, keeping gasoline prices lower and the masses happy in war-time.
- Who knows how much Russian production and distribution can ultimately get disrupted by Ukraine’s attacks on infrastructure, and how much that will nudge up global prices? But while they may limit funds to Russia’s war chest by reducing exports, *they could also lead to an unintended upside shock to global crude oil prices. There is heightened geopolitical risk in Ukraine’s crossing international borders and attacking Russia with western-manufactured armaments.*
- *A black swan event in the form of extreme Russian retaliation, which could conceivably entail the use of nuclear weapons, cannot be ruled out.*
- And it contributes to an already tense geopolitical situation in the Middle East in the wake of last October’s Hamas attacks on Israel (see [“Oil 2024: Black Swans, But More Demand Growth”](#) January 22, 2024). *In some sense it’s astonishing that there seems to be so little risk premium against such things.*

Perhaps counterbalancing these risks is Biden’s demonstrated commitment to do everything in his power to keep oil prices low during an election year with inflation – or “affordability” (again, see [“Video: What you’re not hearing about Kamala Harris imposing price controls to reduce inflation”](#)) – very much on the ballot. As recently as March, before war aims, at the margin, became more politically salient, [Biden was calling out](#)

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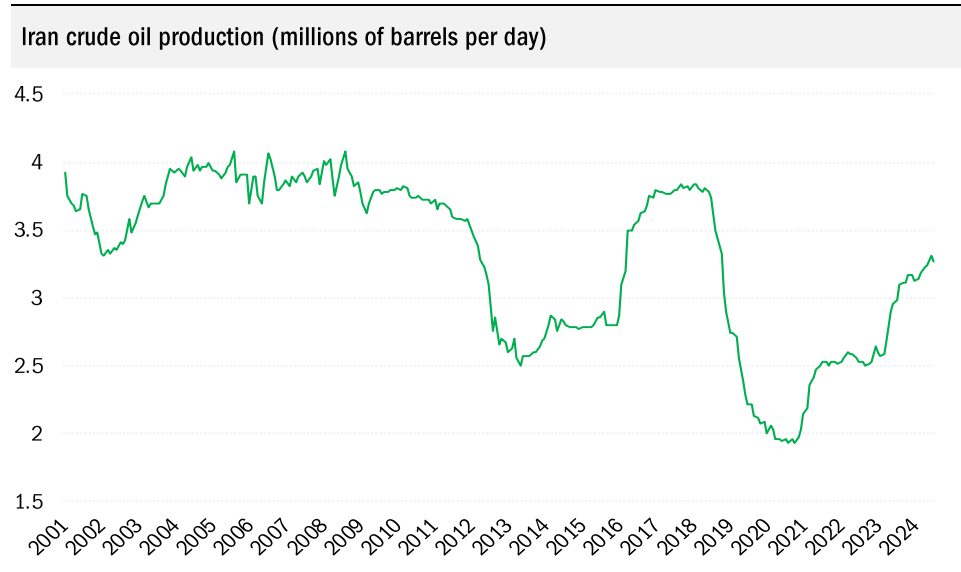
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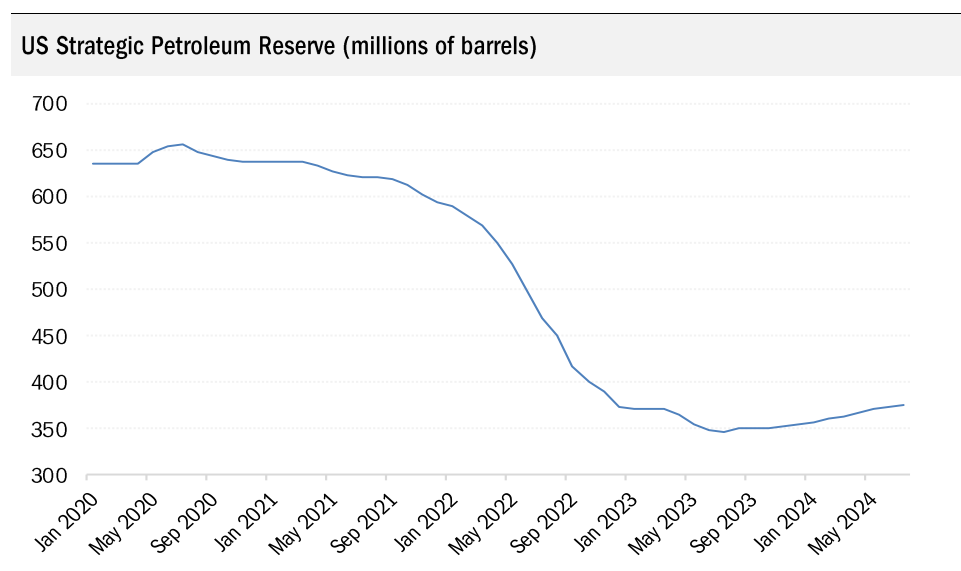
[Zelensky](#) for attacking Russian oil as global oil prices flirted with the top of our then-forecasted trading range.

- At the same time, despite Iran's complicity in an escalating regional terror-war against Israel, Biden has done nothing to enforce the still-prevailing sanctions in place since Donald Trump pulled out of the Iran Nuclear Deal (see "[Iran Deal: More Fire, More Fury, Pure Trump](#)" May 9, 2018). So since Biden took office, [Iranian production has risen](#) from below 2 million barrels per day to almost 3.5 million (please see the chart below).



Source: Bloomberg, TrendMacro calculations

- In 2022, Biden drained the Strategic Petroleum Reserve (please see the chart below) by almost 300 million barrels to help fellow Democrats at the polls during the mid-term congressional elections set against the peak of inflation. Despite numerous promises to



Source: DOE, TrendMacro calculations

restock, his administration's [on-again off-again](#) purchases have seen inventories rise by less than 30 million barrels – or about 10% of what he sold off in 2022. Now, [Biden's administration is selling](#) one million barrels of the Northeast Gasoline Supply Reserve, effectively closing the decade-old reserve for PADD 1.

Such measures to increase supply have probably run their course. And now the new strategy to combat Russian aggression is aimed at reducing supply (and it entails the risk of unintended consequences). We see more upside potential for oil than we had before.

- That view would be complicated if Trump were to be elected president.
- He would surely deregulate energy exploration, production and transport in the US, and that would increase supply eventually.
- But he would just as surely start enforcing sanctions against Iran, and that would quickly reduce supply.
- If he were able to live up to his campaign promise to swiftly broker a peace in Ukraine, it's not clear what difference that would make. Risk of a disruptive black swan event would be taken off the table, for what that's worth. But with the Urals discount to Brent already gone, it's not clear what difference it would make to have Russian oil exports get re-integrated into the global supply network.

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### Bottom line

The discount in Russian oil exports has almost entirely evaporated. The West's \$60 price-cap on Urals crude has proven unenforceable, especially against a poor nation like India which has emerged as the dominant new buyer since the invasion of Ukraine. India's refineries have borne the sunk costs of adapting to Russian crude, and no longer require the discount they could command two years ago. Now Ukraine is attacking refining and other infrastructure on Russian soil and making a large dent in export capacity. This risks a black swan event in which Russia could use nuclear weapons in retaliation for attacks on its homeland with Western arms. Oil prices are not higher because the Biden administration has stopped enforcing sanctions on Iran, and is making only tiny moves to refill the drained SPR. A Trump win in November would increase supply by deregulating the domestic industry but reduce it by clamping Iran sanctions back into place. We are nudging up our trading range for Brent to \$75 to \$90. ▶